No. 16201

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BANKLINE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the Tax Court of the United States.

REPLY BRIEF FOR THE PETITIONER.

MELVIN D. WILSON,
MELVIN H. WILSON,
621 S. Hope Street,
Los Angeles 17, California,
Attorneys for Petitioner.

FILED
MAY -4 1959
PAUL P. O'BRIEN, C

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

PAGE

Comments on respondent's statement of the case ... 1

Argument ... 5

I.

The Tax Court erred in holding that petitioner's alleged motive in getting capital gain treatment on the $85,000 induced the parties to make the form of the contract vary from the substance ... 5

II.

The casinghead gas contracts, or an interest in them was sold to signal ... 11

Conclusion ... 14

TABLE OF AUTHORITIES CITED

Cases

PAGE

Arrington v. United Royalty Co., 188 Ark. 270, 65 S. W. 2d 36, 90 A. L. R. 765 13

Booth v. Hairston, 193 N. C. 278, 136 S. E. 879 14

Crane v. Commissioner, 331 U. S. 1 .... 11, 12

Hormel v. Helvering, 312 U. S. 552 .... 12, 13

J. I. Case Threshing Mach. Co. v. Huber, 160 Mich. 92, 125 N. W. 66 14

Signal Gasoline Corporation, 25 B. T. A. 861 7

Wadsworth v. Union Pac. R. Co., 18 Colo. 600, 33 Pac. 515 14

No. 16201

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Bankline Oil Company,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

Petition for Review of Decision of the Tax Court of the United States.

REPLY BRIEF FOR THE PETITIONER.

Comments on Respondent's Statement of the Case.

The Tax Court and the respondent have in their statement of the case used, in place of facts, conclusions of law or fact. For example on page 11 of his brief, the respondent says:

> "All natural gasoline produced by Signal under the contracts with the producers was delivered to Standard Oil Company of California *for the account of taxpayer* pursuant to an exchange agreement." (Emphasis supplied.)

This expression is misleading since it ignores the fact that petitioner bought the gasoline from Signal and di-

rected Signal to deliver it to Standard Oil Company rather than to petitioner. [See Ex. 7, Tr. 203, 204.]

On page 12 of his brief, respondent quoting the Tax Court said that:

> "Signal thereupon deducted its charge of 2½¢ per gallon from taxpayer's payment and returned the amount remaining to taxpayer."

Signal bought the wet gas from the producers, converted it into gasoline, propane and dry gas, sold the gasoline to petitioner, and the propane and the major part of the dry gas to others and billed the buyers for the gasoline and propane and dry gas and received the amounts thereof. Signal paid 100% of the dry gas proceeds to petitioner and paid to petitioner 70% of the sale proceeds of the gasoline and propane, pursuant to Exhibit 3. [Tr. 182-185.]

On page 12 of his brief the respondent made the same type of comment concerning the liquid propane gas and the same objection is made.

On pages 16 and 22 of his brief, the respondent points out that petitioner in its tax return for 1952 did not refer to the sale of the eight casinghead gas contracts. Since the contracts cost petitioner nothing, no investment therein appeared on its books. [Tr. 57, par. 8.] Hence, there was nothing to deduct on its tax return, so the full $85,000 received in the "package deal" was reported as long-term capital gain.

The Commissioner's representative had no trouble, however, in ascertaining that $85,000 was reported as the

sale price of the eight casinghead gas contracts. [Tr. 14-15, 269.]

Of course, the purported fact finding in the respondent's brief near the bottom of page 17 that the $85,000 was a payment by Signal to taxpayer for being engaged to render services to the taxpayer is a pure conclusion of law and is not supported by the evidence.

On pages 22 and 43 of his brief, respondent makes a point of the fact that the percentage of the proceeds of the sale of gasoline and propane which Signal was permitted to keep started out to be 30% but by December of 1954 it had become "almost 32%."

Respondent, however, overlooks the fact that Exhibit 3 fixes Signal's share at 2½¢ when 21# RVP natural gasoline in the Signal Hill Oil Field sells at 8⅓¢ per gallon. [Tr. 182.] Now, by December 1954 the RVP (*Reed* vapor pressure) of natural gasoline sold by Signal was 28#, and the price was 10.28¢. This resulted in Signal's share being $.032563025 instead of $.025. [Tr. 205.] In other words, when the vapor pressure of the natural gasoline varies, the price varies, and Signal's share varies percentage-wise. That is why throughout petitioner's original brief it referred to the interest which it sold to Signal as approximately 30%. Consequently, where on page 22 of his brief, the respondent says that "taxpayer would hardly contend that it sold a fluctuating percentage interest," he is in error. It did so, as the interest depended upon the vapor pressure of the gasoline.

Respondent, on page 42 of his brief, contests the statement made by petitioner on page 24 of its brief that the parties have treated the transaction on their books and tax returns as a sale of approximately a 30% interest and the reservation by petitioner of the balance of the rights under the casinghead gas contracts. It is believed that petitioner's brief, pages 24 and 25 wholly supports its said statement and that the parties have treated the transaction as a sale of a 30% interest in the contracts.

Respondent argues on pages 28 and 29 of his brief that Signal did not assume petitioner's obligations to make royalty payments in kind or otherwise to the gas producers, but as shown in Exhibit 3 [Tr. 184], Signal agreed that "such procedures of metering, testing and accounting (which it uses) shall conform with the provisions of the agreements described in Exhibit A, as modified from time to time by usages and customs in the industry." This certainly included the "accounting" responsibility for paying royalties in kind. As shown on page 182 of the Record, Signal bought the leases, contracts and other purchase agreements held by petitioner and they were specifically described in Exhibit A and by reference made a part of the agreement. Petitioner's sale price (and Signal's cost) of the contracts included the amounts payable to the gas producers, since Signal agreed to pay such amounts to petitioner, even though petitioner was not released from its liability to pay such royalties.

ARGUMENT.

I.

The Tax Court Erred in Holding That Petitioner's Alleged Motive in Getting Capital Gain Treatment on the $85,000 Induced the Parties to Make the Form of the Contract Vary From the Substance.

The predominating viewpoint in the Tax Court's opinion and respondent's brief, is that petitioner in substance employed Signal to process petitioner's wet gas, but in order for petitioner to get capital gain treatment on $85,000, petitioner couched the transaction in the form of a sale of the wet gas contracts for $85,000 and agreed to pay Signal an excess processing fee for each year of the anticipated ten-year term. In other words, respondent says that because of a tax avoidance motive the substance of the contract was different from the form.

Now let us see how this idea works out. The estimated production of the contracts as of the date Exhibit 3 was signed, November 1, 1952, was 2,326,875 gallons per year. On page 235 of the Transcript, Mr. Green testified that the gas volume from the eight contracts was about three quarters of a million cubic feet of gas per day and that the gasoline content for one thousand cubic feet of gas was between eight and nine gallons. This would work out to be 6,375 gallons per day or 2,326,875 gallons per year.

The normal processing charge was $.0075 per gallon [Tr. 241], whereas Sgnal was to keep $.025 per gallon [Tr. 183] ($.0175 more than the above $.0075). The excess processing charge paid by petitioner to Signal, according to respondent, was therefore $.0175 times 2,326,875 or $40,720.31 per year. On a ten-year level production basis the excess processing charge to be paid by petitioner to Signal, according to the respondent, would therefore be

in the neighborhood of $407,000. Now, for this excess payment petitioner received $85,000, according to the respondent. This does not look like a good bargain for petitioner nor one that businessmen would make unless there was an exceedingly strong tax motive.

What was the tax motive for making the excess payments? To save 26% of $85,000 or $22,100, according to respondent. This is less than one year's alleged excess processing fee or charge.

Respondent claims that the form of the contract relating to the casinghead gas contracts was a sham and unrealistic and different from the substance, because petitioner had a tax motive.

But the alleged tax motive as suggested by the respondent appears unrealistic and ridiculous and worth nowhere near the price petitioner paid for it, as alleged by respondent. It will be noted that petitioner did not in its returns, claim capital gain treatment on the further net amounts it received from petitioner under Exhibit 3. [Tr. 270.]

Mr. Aubert, the President of petitioner, testified that petitioner was selling the casinghead gas contracts to Signal, along with some other capital assets, for $135,000 and further amounts to come out of production. He said that he never discussed with Mr. Green, or Signal or anyone the matter of giving Signal a job of processing petitioner's gas and getting a bonus from Signal for the contract. [Tr. 247.] Mr. Green testified to the same effect. [Tr. 240.] Petitioner reported in its tax returns, and evidently always intended to report the full $135,000 as a sale of capital assets. In negotiating the sale it did not consider that it had any tax avoidance motive in the matter.

Signal had a mild tax and accounting motive, namely, that of breaking up its total cost of $135,000 into land, depreciable buildings and equipment and amortizable contracts. These elements all had different lives and it was incumbent upon Signal to allocate the purchase price over these elements for accounting and tax purposes. Compare *Signal Gasoline Corporation,* 25 B. T. A. 861, Item 4. Now while Signal's tax motive was mild and proper, to get the allocation of costs, it was willing to give the indemnity agreement that petitioner would be accorded capital gain treatment on the $85,000.

If it had been petitioner's motive to get a tax avoidance benefit, petitioner should have given Signal the better of the bargain. As the transaction actually occurred, petitioner got the better bargain as it got the indemnity agreement and 70% of the gasoline and propane and 100% of the dry gas, plus $85,000 for the casinghead gas contracts, the going rate for which was normally only 55% of the production.

If petitioner had any tax avoidance purpose to serve through the *form* of this transaction, then it was very thoughtless or inconsistent in its bookkeeping methods. As pointed out by the respondent, petitioner kept its books practically as it had before the transaction with Signal and did not keep them consistently with the form of Exhibit 3.

Petitioner always expected to report the $135,000 as proceeds from the sale of capital assets and only took the precaution that the allocation requested by Signal would not upset that treatment. As stated before, petitioner has never treated the amounts received from Signal, under the terms of Exhibit 3, other than $85,000, as long-term capital gain. Consequently, the only tax motive that

could possibly be imputed to it was a desire to get long-term capital gain on $85,000. Since this benefit is limited to 26% or $22,100 it is inconceivable that petitioner would give to Signal a bargain of over $40,000 a year or a total of around $400,000, to get this small tax benefit. To suggest therefore that the form of the transaction differed from the purpose so that petitioner could save a tax of $22,100 through paying $400,000 therefor is utterly absurd.

The respondent has imputed a motive to petitioner's officers and directors which would clearly indicate that they were improvident and incompetent. The respondent has built his whole case on the proposition that petitioner, for $85,000, agreed to give Signal an excess processing fee of $40,000 per year for a period which was expected to run for at least 10 years. The alleged purpose of making this improvident contract was that it was hoped it would save petitioner $22,100 in taxes.

That the officers and directors of a multi-million dollar oil company would enter into such an improvident contract is unreasonable, hence, the backbone of the respondent's case is based on an absurd premise.

If petitioner's officers had had such a tax motive as suggested by respondent, they surely would have kept their books and filed their tax returns so as to bear out that premise. Since they were innocent of any such ridiculous tax motive, their bookkeeping was dominated by a desire to show their liabilities for royalties to gas producers. The bookkeeping method used, completely negatived any tax conscious motive.

It is hardly conceivable that the petitioner's officers would have stretched so far to try to save a $22,100 tax

and then been negligent in failing to keep the books in a manner that would have supported that tax motive.

The facts of the matter are that petitioner and Signal had properties in two places which would be more valuable if combined in one ownership. Petitioner negotiated to sell all of such properties to Signal—a lease, tanks, a pier in Santa Barbara County, a casinghead gas plant and its wet gas supply contracts in Signal Hill. All of these items were capital assets and petitioner expected to treat them as such on its tax returns.

The contract of sale would be mutually advantageous to the two parties. Petitioner had very little use for the property in Santa Barbara County, whereas Signal did. On Signal Hill again petitioner had a declining use for the assets whereas Signal could use them to advantage.

All of the assets were easily capable of evaluation excepting the casinghead gas contracts in Signal Hill. The value of those contracts depended upon future production. It was customary in the sale of such contracts to base the ultimate sale price on ultimate production. At Signal Hill another little complication was present. The gas gathering lines of petitioner were old and some of petitioner's employees who serviced them were old. Signal did not want to take over the responsibility for either of these matters. Consequently petitioner sold and Signal bought an interest in the casinghead gas contracts and petitioner reserved an interest in them and assumed the responsibility for keeping up the gas gathering lines and retaining the ageing employees.

Petitioner anticipated no particular tax problems in treating the $135,000 as received in a sale of capital assets. It was only when Signal wanted to segregate that amount among the different classes of assets being pur-

chased that petitioner became disturbed. It was not sure of the valuation being put on the casinghead gas contracts by Signal, and it possibly knew that the government litigates capital gain treatment on patents and other rights where the payments are based on continuing operation or production. Consequently, it demanded the indemnity agreement, as to the $85,000 only.

But even then petitioner did not show any tax consciousness in its bookkeeping. Its bookkeeping was dominated by its necessity of showing the basis of the royalties payable to gas producers, and not by any tax avoidance motive.

Courts might put a different interpretation on the contract between petitioner and Signal with respect to the casinghead gas contracts, but no reasonable person could impute such a ridiculous intent to petitioner's officers as has the respondent and the Tax Court. Without any contradiction, the officers of petitioner and Signal testified that they negotiated the sales of the gas contracts and never discussed petitioner's employing Signal to process the gas for it, and most certainly did not discuss the utterly ridiculous idea of petitioner agreeing to pay Signal an excess processing fee and receiving in its place compensation therefor, all for the purpose of getting capital gain treatment on such compensation.

This case should be stripped of any tax consciousness or tax avoidance ideas or motives. When so stripped we can get down to the basic problem of whether petitioner sold the contracts for $85,000 and later payments or an interest in the contracts for $85,000.

II.

The Casinghead Gas Contracts, or an Interest in Them Was Sold to Signal.

It is clear that the casinghead gas contracts were capital assets in the hands of petitioner and that they became capital assets in the hands of Signal. It is also a manufacturer and casinghead gas operator.

Signal received from petitioner the exclusive right to use the wet gas supply contracts for their entire life. Signal could assign the contracts and receive consideration therefor. It owned them.

The only problems worth discussing are the facts that petitioner was not released from its obligation to the wet gas producers and that petitioner continued to maintain its gathering lines and meters and to pay the royalties to the wet gas producers. (Petitioner in its opening brief, pages 29 and 30, has answered the respondent's argument that the contract, Exhibit 3, was not assignable by Signal.)

In these matters petitioner was merely acting in its own interest as to approximately 70% and as to the 30%, as an agent for Signal.

Signal agreed to pay petitioner more than enough to enable petitioner to satisfy the underlying royalties to the wet gas producers. Unless the royalties to the wet gas producers were paid, Signal's rights would have been wiped out. Signal took the contracts subject to such royalties, and hence Signal agreed to pay them. Compare *Crane v. Commissioner,* 331 U. S. 1, where a seller who (though not personally liable) held property subject to a mortgage and conveyed to a grantee who took it subject to but did not become personally liable for the mortgage.

It was held that though the seller's interest under state law may have been characterized only as an "equity of redemption", nevertheless his interest constituted property and the value of his interest was the value of the whole property. The outstanding mortgage, subject to which the buyer took title was held to be property "other than money" and was therefore part of his cost and of the seller's proceeds of the sale. The payments to the mortgagee were paid by the grantee but the result would not have been different had the grantee paid the amounts to the grantor who had then paid them to the mortgagee.

Applying the principle of the *Crane* case to the instant case, petitioner sold 100% of the contracts and not merely 57½¢ thereof even though petitioner remained liable for the gas producers' 42½% royalties, since Signal took the contracts subject to the liability for such royalties.

As to the gas gathering lines and the reading of the meters, it is frequently the case that a seller of property, merely for convenience, will remain liable to perform some function, to remain on the mortgage, etc.

The patent cases cited in pages 26 to 29, inclusive, of petitioner's original brief, are cogent authority for the proposition that the wet gas contracts, or an interest therein, were sold.

Petitioner sold the contracts or an interest in the contracts and is entitled to long term capital gain treatment thereon.

On pages 39 and 40 of his brief, respondent suggests that petitioner cannot contend in this court that a 30% interest in the contracts, instead of a 100% interest, was sold. He cites *Hormel v. Helvering,* 312 U. S. 552, for the principle that an appellant may not raise issues in the

appellate court which he has not argued in the court below. But the Supreme Court, in that case (p. 556) gave as the reason, "This is essential in order that parties may have the opportunity to offer all the evidence they believe relevant to the issues which the trial tribunal is alone competent to decide; it is equally essential in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence."

The Supreme Court, in the *Hormel* case, recognized, (p. 557) that exceptions to the rule were made so as not to do "violence to the statutes which give the Circuit Court of Appeals reviewing decisions of the Board of Tax Appeals the power to modify, reverse or remand decisions not in accordance with law 'as justice may require'".

In the case at bar, the evidence on the question of a sale of 30% interest in the contracts is the same as it would be on the sale of a 100% interest in the contracts. There is no contention that the respondent could introduce any more documents or evidence if there were a remanding of the case. Hence, the respondent can hardly claim, and has not claimed, that he is surprised to his detriment, by the claim that an interest in, instead of the whole of, the contracts, was sold.

In 3 Am. Jur, page 35, it is stated that questions necessarily involve in litigated issues are open for consideration on appeal, even though they were not specifically raised below. It particularly refers (p. 37) to cases where "a newly advanced theory involves only a question of law arising upon the proved or admitted facts".

The cases cited in support of these exceptions are: *Arrington v. United Royalty Co.,* 188 Ark. 270, 65 S. W. 2d 36, 37, 90 A. L. R. 765; *Wadsworth v. Union Pac. R.*

Co., 18 Colo. 600, 33 Pac. 515, 519; *J. I. Case Threshing Mach. Co. v. Huber,* 160 Mich. 92, 125 N. W. 66, 69; *Booth v. Hairston,* 193 N. C. 278, 136 S. E. 879, 881.

It is axiomatic that the "whole includes all its parts", and that an issue of the sale of a 100% interest in a contract includes the issue of sale of a 30% interest in the same contract.

Conclusion.

The Tax Court erred in holding that the form of the contract differed from its substance because of petitioner's alleged motive to save tax on the $85,000.

The only issue is whether the contracts or an interest therein were sold.

The retention by petitioner of minor or nominal obligations for the obvious convenience of all parties concerned and without any tax motive does not prevent the transaction from being a sale.

The decision of the Tax Court should be reversed, since the petitioner realized long term capital gain on the sale of the contracts.

Respectfully submitted,

Melvin D. Wilson,

Melvin H. Wilson,

Attorneys for Petitioner.